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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 618

CONTINENTAL OIL COMPANY, A DELAWARE CORPORATION, PETITIONER

v.

H. C. JONES, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the District Court (R. 33-40) are reported at 83 F. Supp. 609. The opinion of the Court of Appeals (R. 337-345) is reported at 177 F. 2d 508.

JURISDICTION

The judgment of the Court of Appeals was entered October 31, 1949 (R. 345), and petition for

rehearing (R. 347-364) was denied November 28, 1949 (R. 365). The petition for a writ of certiorari was filed on February 23, 1950. The jurisdiction of this Court rests upon 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

Whether the court below erred in holding that taxpayer, which in 1927 received stock in Reagan County Purchasing Company having an actual fair market value of $244.31 a share and reported it in 1927 for income tax purposes as having a nominal value of $1, may not in 1941, upon sale of a portion of the stock, use $244.31 a share as its cost basis in computing gain or loss upon the sale.

STATEMENT

This case was instituted as a suit for refund of taxes and interest paid by Group No. 2 Oil Corporation (hereinafter called the "taxpayer") on deficiency assessments of income taxes for the years 1940 and 1941 and of excess profits tax for the year 1941. (R. 337.) Taxpayer was thereafter merged with petitioner, the Continental Oil Company, and that company was substituted as plaintiff after the trial but before judgment. (R. 337.) The case in the District Court and court below involved two issues, both of which were decided against petitioner by both courts. (R. 39-40, 341-345.) Petitioner seeks review of the decision below on only one of those issues. (Pet. 1-2.)

The facts found by the District Court pertinent to the one issue on which review is sought by this Court may be summarized as follows:

Taxpayer was incorporated on October 22, 1921, under the laws of the State of Delaware, and was authorized to issue 485,000 shares of stock of a par value of $1 a share. Its entire capital stock was subscribed by, and issued to, Texon Oil & Land Company, a Delaware corporation, for a consideration. (R. 33.)

In 1927 taxpayer received 544 shares of stock in Reagan County Purchasing Company, Inc. (hereinafter called "Reagan"). Reagan stock had been issued to taxpayer, Big Lake Oil Company, Texon Oil and Gas Company, and Group No. 1 Oil Corporation in connection with an agreement entered into in 1924 with the Marland Oil Company, but the stock had been placed in escrow when issued and was to be delivered upon fulfillment of certain conditions. The conditions were carried out and the stock was distributed in 1927. (R. 36.)

The 544 shares of Reagan stock were received by taxpayer in its fiscal year ended March 31, 1927. The shares had a value of $244.31 a share, which constituted income taxable to taxpayer in that fiscal year. Instead of reporting the stock at a value of $244.31 a share, taxpayer reported it at $1 a share. (R. 36.)

As a result of reporting the shares at a value of $1 a share, taxpayer's 1927 return of income showed

a net loss of $39,133.97. Because the return showed that loss, the Commissioner made no examination of the return or of taxpayer's books and records for 1927. Nor was he officially or pointedly informed of the matter by taxpayer. However, the Government agent who examined the books and record of the other two named companies came into possession of knowledge from the books and records of those corporations to the effect that taxpayer had acquired the 544 shares of Reagan stock at the same time and in the same manner as had those two companies. (R. 36-37.)

In 1928 the Commissioner made an examination of the returns and books and records of taxpayer's affiliate corporations, the Texon Oil and Land Company and Group No. 1 Oil Corporation. The Commissioner challenged the report of these companies of receipt of Reagan stock at a nominal value of $1 a share and determined its fair market value on receipt in 1927 at $244 a share, which determination was later affirmed by the courts. Taxpayer did not inform the Commissioner that the same situation existed with respect to its income for 1927, nor did it in any manner advise the Commissioner that it erred in reporting the stock at a nominal value of $1 a share in 1927 until the filing of its return of income in 1941. (R. 37.)

No tax deficiency was assessed against taxpayer for the fiscal year ended March 31, 1927. The revenue agent who made the examination and audit of

the books and records of Texon Oil and Land Company and Group No. 1 Oil Corporation did not make an examination of, or report on, the income tax return and the books and records of taxpayer for the fiscal year ended March 31, 1927, and the Commissioner was not informed of taxpayer's affairs other than through its return of income as filed by it and the knowledge gained by his agent in examining the other two above-named corporations. (R. 37.)

In its taxable year 1941 taxpayer sold 250 shares of the Reagan stock which it had received in 1927. The sale price was $3,750. Taxpayer reported a loss thereon in its return for 1941 of $57,328.68, arrived at by using as a basis, $244.31 a share or $61,078.68. (R. 38.)

Upon and after an examination and audit of taxpayer's 1941 tax return and its books and records, the Commissioner held that taxpayer's basis for the shares was zero and disallowed the deduction of $57,328.68 claimed by taxpayer as loss upon the sale of the 250 shares. (R. 38.)

Taxpayer has failed to establish by a fair preponderance of the evidence that it suffered a net loss during 1941 and that it did not in 1941 earn normal and surtax net income in the amount of $54,968.06 and excess profits tax net income in the amount of $60,547.83 as determined by the Commissioner. (R. 38.)

By its conduct and treatment of the Reagan stock received by it in 1927, taxpayer is estopped from questioning the treatment accorded the stock in his final determination of tax liability for the year 1941. In any event the Commissioner is entitle to recoupment and set-off for the full amount of the tax which he would have been entitled to exact from taxpayer in 1927 had taxpayer properly reported and paid a tax on the stock in 1927. (R. 39.)

The District Court's conclusion of law as to the Reagan stock was as follows (R. 40):

> 5. The gain to plaintiff on receipt of the shares of stock in Reagan County Purchasing Company, Inc. in 1927 was $244.31 per share. This gain was not reported in its return of income for said year and no tax was paid thereon. Upon the sale in 1941 of 250 shares of stock in said company by plaintiff, the Commissioner of Internal Revenue on account of the prior action of the plaintiff in 1927, properly determined that a zero basis should be used by plaintiff in determining the gain on the sale in 1941. By reason of its said action in the prior year, plaintiff is precluded under the doctrines of estoppel and recoupment from using the correct cost basis of such shares in order to establish and claim a loss for income tax purposes upon the sale thereof in 1941.

Affirmance of the District Court's decision on appeal was based upon what may conveniently be termed "quasi-estoppel". (R. 344-345.)

ARGUMENT

Petitioner's grounds for the granting of a writ of certiorari consist principally of asserted conflicts with six different decisions. (Pet. 9-10.) The asserted conflicts are superficial, we submit, the differences in result in the cases being attributable to the differences in facts.

1. The decision below is not in conflict with *McEachern* v. *Rose*, 302 U. S. 56. In that case the taxpayer had made overpayments of tax for the years 1929 through 1931 and the Government, on the theory of recoupment, sought to credit such overpayments on the taxpayer's unpaid tax for 1928 the collection of which was barred by the statute of limitations. It was held that recoupment was precluded by Sections 607(a)(2) and 609(a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, which are similar to Sections 3770(a)(2) and 3775(a) of the Internal Revenue Code (26 U.S.C. 1946 ed., Secs. 3770, 3775), relied upon by petitioner and quoted in the appendix to its petition. In the present case no admitted overpayment is involved. The decision below does not rest on the right of recoupment. The court below has simply held that, since the taxpayer in 1927 reported the Reagan stock as income at a value of $1, it may not change its position and use a higher basis for determining gain or loss on the sale of the stock in 1941. The question is whether this is a proper defense in petitioner's suit for refund

of the 1941 deficiency determined by the Commissioner and paid by taxpayer. The *McEachern* case does not purport to decide such an issue. Moreover, according to the Court's decision in *Stone* v. *White,* 301 U. S. 532, 538, the statutes applied in the *McEachern* case do "not override a defense based on the estoppel of the taxpayer" and, as the Court stated in the *McEachern* case itself (p. 59), equitable principles control in the absence of any applicable statutory provision.[1]

2. Similarly, the decision below is not in conflict with *American Light & Traction Co.* v. *Harrison,* 142 F. 2d 639 (C.A. 7th). As the opinion in that case states (p. 641), it was there conceded that a previous decision of the same court had settled the question of estoppel against the Government. The case involved recoupment, the taxpayer having made an admitted overpayment for 1933 which the Government sought to credit against the tax which the taxpayer should have paid for 1928.

3. In *Salvage* v. *Commissioner,* 76 F. 2d 112 (C.A. 2d), it was held that estoppel does not arise

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[1] Although the decision below was not based upon recoupment, we do not concede that the doctrine of recoupment is not applicable in the present case. *Rothensies* v. *Electric Battery Co.,* 329 U. S. 296, seems to hold that, while recoupment does not allow one transaction to be offset against another, a transaction which is made the subject of suit by a taxpayer may be examined in all its aspects and judgment rendered that does justice in view of the one transaction as a whole.

from an innocent mistake of law. This Court's decision in the same case (*Helvering* v. *Salvage,* 297 U. S. 106) stated that the defense of estoppel was not before the Board of Tax Appeals (now the Tax Court) and for that reason the Court of Appeals should have passed the point. The Court added, "Furthermore, the facts disclosed give it no support" (p. 109). Decision in the present case was based upon taxpayer's action in reporting the Reagan stock in 1927 at a nominal value of $1 when it actually had a value at that time of $244.31 a share. (R. 344-345.) The court below specifically pointed out that, if this action was due to a mistake, it was a mistake of fact and not of law. (R. 344.) The decision below does not purport to hold that estoppel may arise from an innocent mistake of law and, accordingly, the asserted conflict with the decisions in the *Salvage* case is nonexistent.[2]

4. In *Schmidlapp* v. *Commissioner,* 96 F. 2d 680 (C.A. 2d), the taxpayer had the option of calculating gain or loss on the sale of stock in either of two ways. He had purchased shares of Chase National Bank stock and sold some of them in 1929, when he

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[2] Nor is there any basis for petitioner's assertion (Br. 17) that taxpayer's error was merely a mistake of law. The assertion is based on a suggestion that taxpayer should not be censured "for having guessed wrong in contending that it [the Reagan stock] constituted income in 1924, when it had only a nominal value, and not in 1927, when it had greatly enhanced in value". (Br. 17) The record does not show that taxpayer contended that the stock constituted income in 1924. On the contrary, it was in 1927, not 1924, that taxpayer reported the stock *as income* at a nominal value.

used one method of reporting his gain or loss. In 1932, when he sold the remainder, he used the other method and it was held that his choice as to the 1929 transaction did not preclude him from changing to the other method as to the 1932 transaction. The case is therefore factually distinguishable from the present case. No direct conflict with the instant decision is apparent from the opinion, which, however, is not entirely clear. The case was decided by the Court of Appeals for the Second Circuit and that court does not deny that estoppel may be available to the Government in a proper case. See *Helvering* v. *Schine Chain Theatres,* 121 F. 2d 948 (C.A. 2d).

5. In *Ross* v. *Commissioner,* 169 F. 2d 483 (C.A. 1st), the taxpayer had constructively received income in 1927 to 1932, consisting of accrued salaries, which he did not report and it was held that such income could not be taxed to him in 1939 because, as a matter of law, the income had been received, and was taxable, in the previous years of constructive receipt. The subject of estoppel in tax cases was discussed and the court's holdings in that connection were as follows: (1) That "in the absence of misstatement of fact, intentional or otherwise" (p. 496), the taxpayer was not estopped from asserting that the income was taxable only in the years in which constructively received; (2) that a mere failure to report income is not a representation that such income has in fact not been received;

and (3) that, since the Commissioner had full knowledge of the accrued salaries, he was justified in relying on the taxpayer's returns for no more than the taxpayer's honest understanding of his liabilities and it was the Commissioner's duty to make up his mind as to the taxability of the accrued salaries.

As the decision reflects (pp. 493-494), the conflict in decisions in respect of the application of the estoppel doctrine in tax cases results principally from the application of the doctrine by some courts in cases where reliance is not based upon any misstatement of fact, innocent or otherwise. This is not such a case and the decision below definitely does not conflict with the first two of the above-numbered holdings in the *Ross* case. As already stated (*supra,* p. 9), the court below pointed out that if taxpayer's action in listing the Reagan stock as income at a value of $1 was a mistake, it was a mistake of fact and not of law, and it was that type of mistake to which the court below held estoppel applicable.

Petitioner may be correct in asserting (Pet. 10) that the decision below is in conflict with the *Ross* decision on the question whether the Commissioner is bound by knowledge gained from sources other than the taxpayer's returns and records, but we believe the conflict, if it exists, is not such as to justify the granting of the instant petition for a writ of

certiorari. As to the effect of the Commissioner's knowledge, the court below held (R. 344):

> It is true, the Commissioner learned the value of the Reagan stock through his investigation of affiliated companies of the taxpayer, but the Commissioner was only charged with knowledge of the facts reflected in the taxpayer's return or facts he learned from an investigation of that return. To hold otherwise would place an insuperable burden on the Commissioner.

The *Ross* decision held in effect that the Commissioner was bound by knowledge obtained from other sources, but the evidence of the Commissioner's knowledge was used only to support the conclusions that the Commissioner was justified in relying upon the taxpayer's returns for no more than the taxpayer's honest understanding of his liabilities and that it was the Commissioner's duty to make up his own mind as to the taxability of the accrued salaries. The *Ross* opinion also stated that from the mere failure to report income no more significant inference should be drawn than the taxpayer's own interpretation of the law (p. 496). In other words, the *Ross* case was regarded as involving a mistake of law on the part of the taxpayer of which the Commissioner had knowledge. To reiterate, in the present case it was an error of fact and not of law—taxpayer's misrepresentation of the value of the Reagan stock, not the failure to report the stock as income—on which the court below predicated its

application of the estoppel doctrine. It is doubtful that the statements in the *Ross* opinion as to the Commissioner's knowledge were intended to cover such a situation, especially since the ultimate conclusion in that case as to estoppel (p. 496) was simply that estoppel is inapplicable in the absence of misstatement of fact, intentional or otherwise. In any event, the difference in the facts of the two cases is such as to preclude the existence of a square conflict.

6. In *Joyce* v. *Gentsch,* 141 F. 2d 891 (C.A. 6th), the taxpayer in 1935 reported a loss for worthless stock of two companies, the loss was disallowed by the Commissioner, and the taxpayer subsequently sought a refund for 1934 on the ground that the same stocks had become worthless in 1934. The case is like *Ross* v. *Commissioner,* 169 F. 2d 483 (C.A. 1st), in that it did not involve a misrepresentation of fact. Nor are the statements in the opinion with respect to the Commissioner's knowledge inconsistent with the statements of the court below in the same connection. The *Joyce* opinion states that the Commissioner possessed all essential information upon which to base an opinion as to when the stocks became worthless, but the Commissioner's knowledge in this respect was related to the taxpayer's returns, for in 1937, when taxpayer's 1934 tax was recomputed under a proposed settlement, the taxpayer's claim for deduction of the stock losses in 1935 was pending before the Commissioner. There

would therefore appear to be no conflict between the decision below and the *Joyce* decision.

7. In *Commissioner* v. *Farren,* 82 F. 2d 141 (C.A. 10th), certiorari granted, 298 U. S. 653, certiorari dismissed, 299 U. S. 617, where the taxpayers in 1918 received shares of stock as compensation for services and did not report the stock as income because they honestly believed no return was necessary until the stock was sold, it was held that the taxpayers were required to use a zero basis in determining gain on the sale of the stock in 1926. That case, unlike the present one, involved a mistake of law on the part of the taxpayers.

CONCLUSION

The decision below is correct and there is no clear conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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